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May 15, 2006

AGENDA ITEM 6a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** External High Yield Manager Annual Review
- II. PROGRAM:** External High Yield Fixed Income
- III. RECOMMENDATION:** Renew the contracts for all four of CalPERS' external high yield managers for a period of one year. The four managers are:
- Highland Capital Management L.P.
 - ING Ghent Asset Management, LLC
 - Nomura Asset Management Inc.
 - Pacific Investment Management Company

IV. ANALYSIS:

Background

The CalPERS' external high yield program (Program) consists of four managers, all placed under contract in February 2002. The managers were funded in February, March, and April of 2002 under annual contracts. All managers have been with CalPERS since the inception of the Program. The objective of the Program is to provide diversification and return enhancement within the CalPERS fixed income investment allocation.

Recommendation

Staff and Wilshire (Attachment 1) are recommending renewal of all four contracts for a period of one year. It should be noted that staff is closely monitoring ING Ghent (ING). Staff has reduced exposure to ING until staff believes that the market environment is more conducive to ING's style. Staff will increase the allocation to ING once staff believes that the market environment is more

favorable too ING's style. Each contract contains a provision allowing for termination by either party with thirty days notice.

Market Environment

The high yield market has experienced moderate volatility over the majority of the reporting period (March 31st, 2005 to March 31st, 2006). Returns have remained strong due to continued strong credit metrics over the reporting period. The 12 month default rate over the reporting period was 2.97%, which was higher than the prior year's 12 month default rate of 0.83%, but well below the average rolling 12 month default rate of 4.40% over the past 25 years. Given the continued favorable environment, the high yield market returned 7.24% versus a return of 1.60% for similar duration treasury securities.

Program Performance

The strategic objective of CalPERS' high yield fixed income program is to provide diversification and return enhancement to CalPERS' fixed income portfolio. The objective of the external managers is to outperform the (Benchmark) CalPERS High Yield Cash Pay Index (CALHYCPI) net of all management fees.

Annualized return for the Program since inception was 12.25% versus 10.44% for the CALHYCPI. (See Figure 1 for details) Over the reporting period, from March 2005 month end through March 2006 month end, the Program's return was 8.60% compared to the CALHYCPI of 7.24%, thus producing an excess active return of 136 basis points. There are two major components of the CalPERS' external high yield program. The first section of the Program is invested in the traditional high yield bond market that returned 6.54% over the reporting period which was 0.70% below the return of the CALHYCPI. The second is a distressed bank loan portfolio that returned 17.20% over the reporting period which is 9.96% over the CALHYCPI. Over the reporting period, ING underperformed the Benchmark while the other three managers outperformed. The information ratio since inception for the Program has been 0.20, while the information ratio for the reporting period was 0.77.

Please refer to Table 1 for a summary of Program returns.

Figure 1. CalPERS' External High Yield Program Return vs. CALHYCPI

Source: State Street

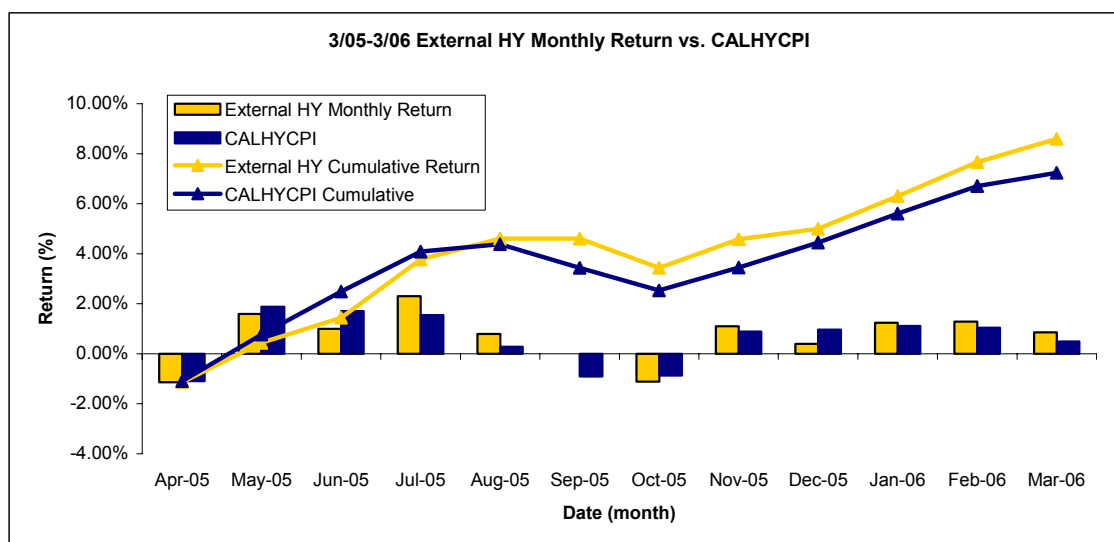


Table 1. Asset under Management per Manager as of 03/31/2006

Source: State Street

Active Managers	Portfolio Performance April 05 – March 06	Benchmark Performance	Excess Return
ING Ghent	3.88	7.24	-3.36
Nomura	7.41	7.24	0.17
PIMCO	7.40	7.24	0.16
Traditional High Yield Total	6.54	7.24	-0.70
Highland Capital Management Distressed Debt Portfolio	17.20	7.24	9.96
Total High Yield Program	8.60	7.24	1.36

Assets Under Management

As of March 31st, 2006, total assets under management for the CalPERS' external high yield program were approximately \$1,480.0 million dollars. Staff increased exposure to the traditional high yield bond market by \$100.0 million in June 2005. During July 2005 through March 2006, staff decreased exposure to the distressed bank portfolio by \$145.4 million, resulting in an overall reduction of exposure to the high yield market of \$45.4 million over the reporting period.

Please refer to Table 2 for a breakout of assets under management by manager:

Table 2. Asset under Management per Manager as of 03/31/2006

Source: State Street

Manager	Portfolio Value (in millions)	Percent of Portfolio
ING Ghent Asset Management, LLC	\$313.3	21.2%
Nomura Asset Management	\$486.1	32.8%
Pacific Investment Management Company	\$461.4	31.2%
Highland Capital Distressed Fund	\$219.2	14.8%
Total	\$1,480.0	100.00%

Individual Managers Performance and Evaluation

ING Ghent:

The investment style of ING Ghent is based on the philosophy of “positive management” which includes goals of maximizing cash interest income, minimizing capital losses/maximizing capital gains through early credit detection, and avoiding default losses through aggressive management. The “positive management” philosophy mandates some specific actions including focusing on credit selection, managing on a total return basis, and earning high coupon income and harvesting gains from credit quality improvements while protecting against principal loss with prompt credit decisions.

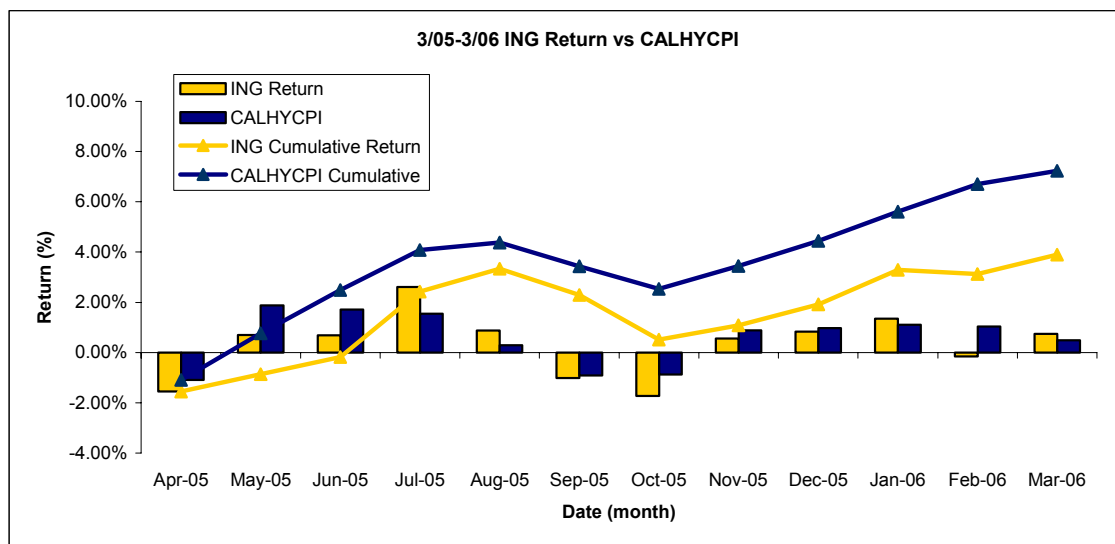
The investment process that ING employs combines elements of “top-down” and “bottom up” analysis. ING begins its investment process with a top-down industry analysis to identify industries with favorable performance and credit fundamentals. In those industries, ING’s portfolio managers will invest in a wide range of issuers. In those industries with acceptable performance and credit fundamentals, they will concentrate investments in the strongest issuers in the industry. ING looks for industries in which the trend of credit ratings changes is neutral or positive, and usually avoids those companies with deteriorating credit ratings.

Over the reporting period, ING’s return was 3.88% versus the CALHYCPI return of 7.24%. (See Figure 2 for details) The manager’s annualized performance since inception was 7.74% whereas the CALHYCPI annualized return was 9.99%. The information ratio since inception for ING has been -0.48, while the information ratio for the reporting period was -1.34. As of March 31st, 2006 ING had \$313.3 million under management for CalPERS.

Over the prior reporting period, from March 2004 to March 2005, ING underperformed by 105 basis points. Staff met with ING in June of 2005 to discuss the portfolio's underperformance. In the subsequent months, ING's performance improved. For the first seven months of the fiscal year, ING outperformed the Benchmark by 44 basis points. However, ING underperformed in February 2006 by 120 basis points resulting in the current fiscal year's underperformance of 54 basis points through March 2006 month end. Staff met with ING in April 2006 to discuss the recent underperformance. Staff has determined that there has been no turnover of key personnel or changes to the portfolio management process at ING. Assets under management have remained near ING's target of \$2 billion. ING's style is vulnerable to negative event risk which was high over the reporting period. Staff believes the recent market environment has not consistently rewarded ING's style. Staff is reducing the allocation to ING until the market environment is more conducive to ING's style of management.

Figure 2. ING Ghent Asset Management Performance vs. CALHYCPI

Source: State Street



Highland:

Highland Capital Management, L.P. currently manages a distressed bank loan portfolio for CalPERS. Staff chose to reduce exposure to this segment of the high yield market since the opportunities available in this segment of the market have diminished due to the maturity of the current credit cycle.

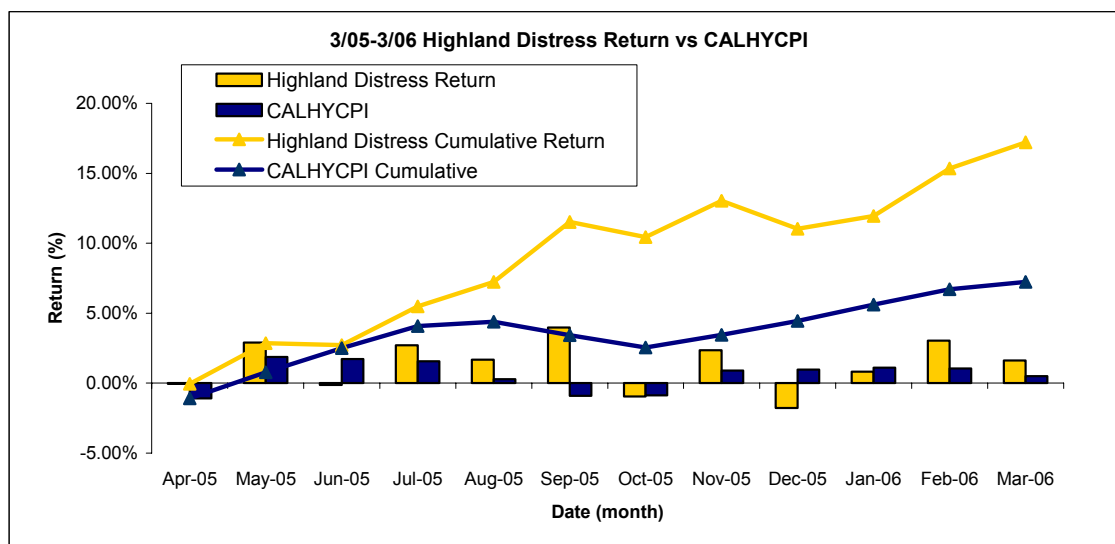
Highland's investment philosophy is based on the belief that fundamental research and a disciplined research methodology produce superior long-term results. Highland's investment approach produces returns with extremely low interest rate volatility and modest credit volatility. As part of Highland's strategy, the firm seeks to invest in industries, sectors, and securities which provide value

on relative basis. The manager invests in senior tranches of the capital structure to mitigate credit risks. In addition, the manager eliminates credits that cannot be fully researched and gives favorable considerations to companies with experienced management team, positive cash flow generating momentum, stable/improving interest coverage ratio, and ability to demonstrate net tangible asset protection on company bank loans.

Over the reporting period, Highland Distress Fund's return was 17.20% versus the CALHYCPI return of 7.24%. (See Figure 3 for details) The manager's annualized performance since inception was 24.47% whereas the CALHYCPI annualized return was 7.76%. The information ratio since inception for the Highland Distressed fund has been 2.16, while the information ratio for the reporting period was 1.50. As of March 31st, 2006 Highland had \$219.2 million invested on CalPERS' behalf.

Figure 3. Highland Distressed Fund Performance vs. CALHYCPI

Source: State Street



Nomura:

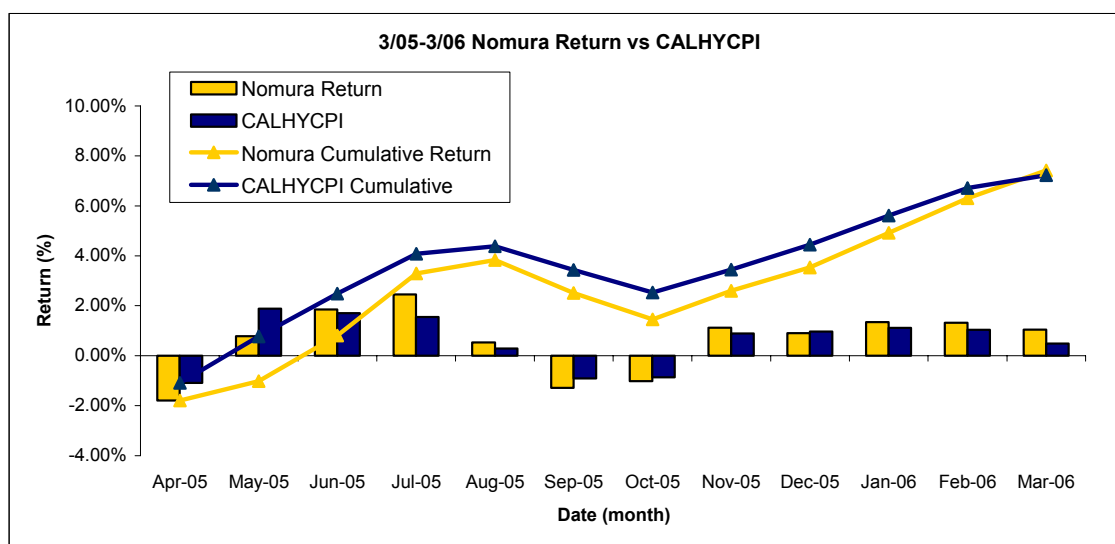
Nomura's investment philosophy is based on a deliberate bottom-up investment approach designed to invest in improving credits with the goal of achieving a coupon and small capital gain, while simultaneously avoiding credit losses. In general, the firm's process revolves around identifying and investing in what it believes to be "strong horse" companies, or those companies that exhibit the potential to de-leverage their balance sheets, generate stable cash flow, and are credit upgrade candidates.

Nomura's investment decision-making process is a collaborative effort with ideas generated by the whole team. By monitoring developments in their assigned industries and trading levels of securities in those industries, Nomura's investment team successfully remains abreast of the market.

Over the reporting period, Nomura's return was 7.41% versus the Benchmark return of 7.24%. (See Figure 4 for details) The manager's annualized performance since inception was 10.81% whereas CALHYCPI annualized return was 10.44%. The information ratio since inception for Nomura has been 0.12, while the information ratio for the reporting period was 0.09. As of March 31st, 2006, Nomura had \$486.1 million under management for CalPERS.

Figure 4. Nomura Asset Management Performance vs. CALHYCPI

Source: State Street



PIMCO:

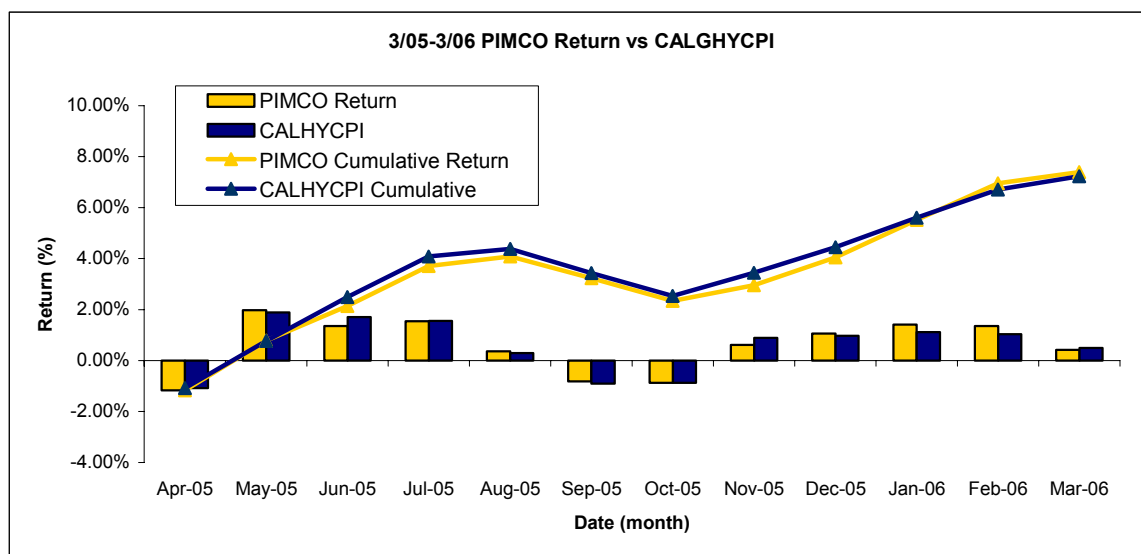
PIMCO's investment philosophy embodies five key principals: 1) focus on higher quality below investment grade credits; 2) a total return approach and preservation of capital; 3) diversification broadly across issuers and industries; 4) use of extensive credit research to identify improving credits; and 5) use of PIMCO's expertise in mortgages and other sectors to identify non-traditional high yield opportunities.

PIMCO believes that analyzing secular economic and political influences is fundamental to sound portfolio decisions. The macroeconomic analysis is combined with a fundamental, bottom-up style of selecting high yield credits. Top-down analysis is used primarily to determine average quality and secondarily duration and yield curve exposures in high yield portfolios. However, it is fundamental, bottom-up credit research that is the primary method of selecting securities and adding value in PIMCO's high yield portfolios.

Over the reporting period, PIMCO's return was 7.40% versus the Benchmark return of 7.24% (See Figure 5 for details). The manager's annualized performance since inception was 10.27%, whereas CALHYCPI annualized return was 9.99%. The information ratio since inception for PIMCO has been 0.11, while the information ratio for the reporting period was 0.23. As of March 31st, 2006 PIMCO had \$461.4 million under management for CalPERS.

Figure 5. PIMCO Performance vs. CALHYCPI

Source: State Street



V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS' Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of staff's efforts to ensure that the high yield fixed income external manager program is performing in line with expectations.

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Investment Officer

Kevin Winter
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Anne Stausboll
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